IN THE COURT OF APPEAL OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

In the matter of a case stated by the Board of Review constituted under Section 118 of the Inland Revenue Act No. 28 of 1979 for the opinion of the Court of Appeal under Section 122 of the Inland Revenue Act No.28 of 1979

Butani Exports Limited,
No. 276,
Rajagiriya Road,
Rajagiriya.

APPELLANT

CA No. CA/TAX/0004/2010
Tax Appeals Commission
No. BRA/VAT/10

v.

Commissioner General of Inland Revenue,
Department of Inland Revenue,
Sir Chittampalam A, Gardiner Mawatha,
Colombo 02.

RESPONDENT

BEFORE : Dr. Ruwan Fernando J. &
M. Sampath K. B. Wijeratne J.

COUNSEL : M.A. Sumanthiran, P.C., with
V. Arulananthan for the Appellant.

Chaya Sri Nammuni, S.S.C., for the Respondent.

WRITTEN SUBMISSIONS	:	24.08.2015, 24.07.2018 & 07.11.2019 (by the Appellant) 02.09.2015, 06.08.2018, 11.15.2019 & 17.02.2020 (by the Respondent)
ARGUED ON	:	24.03.2022
DECIDED ON	:	25.07.2022

M. Sampath K. B. Wijeratne J.

Introduction

The Appellant, Butani Exports Limited, is a limited liability company incorporated in Sri Lanka, engaged in the manufacture and export of garments. The Appellant company entered into an agreement with the Board of Investment of Sri Lanka (hereinafter referred to as 'BOI') in terms of Section 17 of the Board of Investment of Sri Lanka Act[1], as amended, (hereinafter referred to as 'BOI Act').

In consequent to a VAT audit carried out, the Assessor issued the letter dated 19th May 2005 in terms of Section 29 of the Value Added Tax Act No. 14 of 2002, as amended (hereinafter referred to as the 'VAT Act'), communicating the reasons as to why he is not accepting the VAT returns submitted by the Appellant. The letter also contained assessments for the taxable periods of 02092–04033[2] (1st August 2002 – 31st March 2004)

Being aggrieved by the assessment, the Appellant appealed to the Commissioner General of Inland Revenue (hereinafter referred to as the 'CGIR'), against 16 out of the 20 taxable periods (from 31st October 2002 to 31st March 2004 - except the taxable periods ending on 30th November 2002 and 31st March 2003[3]), by letter dated 23rd August 2005[4]. The

[1] As amended by Greater Colombo Economic Commission (Amendment) Act No. 43 of 1980, 21 of 1983, 49 of 1992 and Board of Investment of Sri Lanka (Amendment) Act No. 9 of 2002, 36 of 2009 and 3 of 2012.
The words 'Greater Colombo Economic Commission' in the Long Title to the Greater Colombo Economic Commission Law No. 4 of 1978 was amended by Greater Colombo Economic Commission (Amendment) Act No. 49 of 1992 to read as 'Board of Investment of Sri Lanka'.
[2] Letter marked R1 in the appeal brief.
[3] *vide* document attached to Appellant's letter dated 23rd August 2005.
[4] Letter marked R 3 (a) in the appeal brief.

Appellant submitted that the Appellant company and its subsidiaries only export garments and are therefore, not subject to VAT.

The CGIR heard the appeal and concluded that the assessment should be amended as determined by the CGIR. However, the obligation to pay VAT was upheld.

The Appellant appealed to the Board of Review (hereinafter referred to as the 'BOR') against the determination of the CGIR. In its determination dated 30th December 2009, the BOR confirmed the assessments and dismissed the appeal. The Appellant aggrieved by the BOR's decision moved to state a case to the Court of Appeal on five questions of law. However, the BOR stated a case to the Court of Appeal on three questions of law formulated by the BOR. When the matter on questions of law was agitated by the Appellant before this Court, Court allowed the addition of two other questions raised by the Appellant.

However, the Appellant was not satisfied with not accepting the Appellant's five questions, and only the last two questions of law were accepted by the Court. The Appellant's position was that, the Court of Appeal erred in concluding that the Appellant had no objections for the three questions of law referred to the Court by the BOR. The Appellant moved the issue to the Supreme Court in case No. SC. Spl. LA. 224/2015. The parties agreed before the Supreme Court to accept six questions of law brought to the Supreme Court by their joint motion dated 30th March 2016[5].

Accordingly, the Supreme Court directed this Court to decide on the following six questions of law.

i. **In the totality of the circumstances of this case, did the Appellant Company, having transferred fabric to its fully owned subsidiaries, ensure that the fabrics transferred were in fact, manufactured into garments, exported and foreign exchange realized?**

ii. **Did the Appellant Company misconstrue and/ or misapply and/ or violate the provisions of section 7(2)(b) of the VAT Act in the manner of transfer of fabrics to its fully owned subsidiaries particularly when ex facie they were not arms-length transactions?**

[5] Order made by the Supreme Court on the 31st March 2016

iii. **Was it not the onus placed on the Appellant Company to satisfy the Revenue regarding the absence of any intention to avoid tax liability by tendering any other evidence, if the original documents were not available and to reconcile the exports figures with the fabrics transferred to its fully owned subsidiaries?**

iv. **Has the Board of Review erred in law by failing to inquire into the substantive question of law in interpreting Section 2(3)(b) of the Value Added Tax Act No. 14 of 2002?**

v. **Has the Board of Review misdirected itself failing to draw an adverse inference on the conduct of the Department in failing to produce the original documents pertaining to the Appellant Company, which were admittedly in the Custody of the Department?**

vi. **Has the Board of Review erred in directing the Appellant to produce documents pertaining to the matter in issue when admittedly the said documents are in the custody of the Department?**

The substantive issue to be determined by this Court is whether the fabrics imported by the Appellant and transferred to their subsidiaries, P.N.K. Garments (Pvt) Ltd and Inatub Garments (Pvt) Ltd is subject to VAT as local supplies or eligible for zero rated supplies under Section 2 (3) (b) read along with Section 7 (1) (a) of the VAT Act.

Statutory Provisions

I will start with reproducing the relevant statutory provisions of the VAT Act.

Section 7 (1) (a) reads that;

*"***7.** *(1) A supply of –*

(a) goods shall be zero rated where the supplier of such goods has exported such goods; and

(b) (...)

(c) (...)

(2) Where a registered person supplies any goods or services which is zero rated -

(a) no tax shall be charged in respect of such supply;

(b) the supply shall in all other respects be treated as a taxable supply and accordingly the rate at which tax is charged on the supply shall be zero."

Section 2 (3) (b) reads thus;

"**2.** *(1) (...)*

(2) (...)

(3) The tax on the importation of goods, shall be charged, levied and collected as if which is a customs duty and as if all goods imported in to Sri Lanka are dutiable and liable to customs duty:

Provided however, no tax shall be charged on –

(a)(...)

(b)Any fabric imported by any person, for the purpose of manufacture of garments for export, who has entered in to an agreement with the Board of Investment of Sri Lanka under Section 17 of the Board of Investment of Sri Lanka Law No. 04 of 1978 for the manufacture of garments for export under such agreement, and the transfer of such fabric with or without value addition with the approval of the Director-General of Customs or the Board of Investment of Sri Lanka, to any other person for the purpose of such manufacture of garments for export;"

(c) (...)

(d) (...)
(e) (...)

Since the first, fourth, fifth and sixth questions of law as above are interrelated, I will now consider these four questions together, leaving

aside consideration of the remaining questions of law two and three towards the end of this judgment.

i. **In the totality of the circumstances of this case, did the Appellant Company, having transferred fabric to its fully owned subsidiaries, ensure that the fabrics transferred were in fact, manufactured into garments, exported and foreign exchange realized?**

iv. **Has the Board of Review erred in law by failing to inquire into the substantive question of law in interpreting Section 2(3)(b) of the Value Added Tax Act No. 14 of 2002?**

v. **Has the Board of Review misdirected itself failing to draw an adverse inference on the conduct of the Department in failing to produce the original documents pertaining to the Appellant Company, which were admittedly in the Custody of the Department?**

vi. **Has the Board of Review erred in directing the Appellant to produce documents pertaining to the matter in issue when admittedly the said documents are in the custody of the Department?**

Analysis

The Assessor made the impugned assessment on the basis that fabrics worth of Rs. 37.5M imported by the Appellant and transferred to its two subsidiaries during the taxable period from 1st August 2002 to 31st March 2004 attracts VAT as local sales.

On appeal to the CGIR, the CGIR conceded that the Appellant had declared VAT on fabric at the point of importation[6]. Nevertheless, the CGIR maintained that any subsequent transfer is subject to VAT as a supply in Sri Lanka. However, the following words in Section 2(3) (b) clearly defeats the argument of the CGIR.

[6] Page 3 of the CGIR determination.

"*any fabric imported by any person, for the purpose of manufacture of garments for export, (…) and the transfer of* ***such*** *fabric (…) to* ***any other person*** *for the purpose of such manufacture of garments for export;"*

In the appeal to the BOR, the CGIR deviated from his original reasoning and submitted to the BOR that the Appellant did not obtain the necessary approvals for the transfer of fabric to its subsidiaries in accordance with the law[7].

The Appellant's counter-argument was that the two subsidiaries are wholly owned by the Appellant[8] and therefore the transfer of fabric is consistent with the applicable law.

In response, CGIR argued that since the transactions were not *'arm's length transactions'*, they were subjected to VAT[9]. Further, it was contended that, without documentation on the export of manufactured garments, the exemption cannot be invoked.

The BOR was of the view that, to qualify for the exemption, the Appellant must prove that its two subsidiaries indeed exported garments made from the fabric transferred by the Appellant.

The BOR directed the CGIR to call for documentary evidence from the Appellant to verify whether the transferred fabrics were manufactured into garments and exported by the subsidiaries realizing foreign exchange. Accordingly, the CGIR in his letter dated 25th May 2009 called for documentary evidence that the fabrics were transferred, transformed into garments and exported realizing foreign currency[10]. In response to the above letter, the Appellant informed the CGIR by letter dated 2nd June 2009 that all the requested documents were already submitted to the Inland Revenue Department (hereinafter referred to as the 'IRD') on several occasions and to the BOR as well. Thereafter, BOR noticed the parties to appear before the Board. But the Appellant was unable to produce information required by the BOR. The Appellant's explanation was that all the documents were taken over by the IRD. The Appellant produced the document 'P10' to substantiate the fact that the documents were taken over by the IRD. In 'A10' the officers of the VAT branch of the IRD acknowledged that they took over eight box files, three other files and

[7] Page 2 of the BOR determination.
[8] Ibid.
[9] Page 3 of the BOR determination.
[10] Ibid

another three box files containing Appellant company's shipping documents on 23rd August 2004. In addition, the IRD had taken over bank statements containing Rupees and foreign exchange accounts for the year 2003/2004 and VAT invoices for the period 2003 June to 2003 December and 2004 January to 2004 July. The relevant invoices for the transaction at issue must be commercial invoices. These commercial invoices were already submitted to the BOR by the Appellant ('A 9').

The Appellant's contention is that since the material documents were taken over by the CGIR and not returned, the Appellant was unable to produce those documents to the BOR. The CGIR did not deny the fact that the documents listed in 'A 10' were taken into their custody. But they never produced the documents at the BOR. Nevertheless, the Respondent cited the decisions of the Supreme Court in the cases of *Guillian v. Commissioner of Income Tax*[11] and *Gamini Bus Company v. Commissioner of Income Tax*[12] and submitted that the onus was on the Appellant to prove that the Assessor's assessment was excessive or erroneous. I do agree with the contention of the Respondent. Yet, the issue is whether the Respondent put the Appellant at a disadvantage and thereafter, placed the burden on the Appellant. The BOR's observation to that effect was that the Appellant could have obtained the required documents from the bankers of the subsidiaries, Central Bank, BOI and Customs Department or from other statistical reports. Accordingly, the BOR determined that the Appellant's continued refusal to present the relevant documentation to the Board, despite several opportunities had been offered to the Appellant, the Board had no alternative, but to confirm the assessments and dismiss the appeal.

The first question of law is whether the Appellant company having transferred fabric to its subsidiaries ensured that those were manufactured into garments and exported to realize foreign exchange. It is beyond dispute that the fabric was transferred by the appellant to the other two companies.

The Appellant submitted the letter dated 15th June 2005 ('A 8') by which the Appellant requested the BOI to confirm that the other two companies were hundred percent exporters of garments. The BOI, in a hand written note made on the same letter confirmed that the above-mentioned enterprises are hundred percent export-oriented projects under the BOI.

[11] 51 N.L.R 241 at pp. 247 and 248

[12] Ceylon Tax Cases Vol. I p. 473

The document attached to 'A 8' is Circular No. EC/6/VAT/01 dated 26th July 2002 of which clause 1.2.1 under 1.2 'transfers' clearly states that the transfer of '*imported fabric from a garment manufacturer to inter or intra Zone project or BOI garment manufacturer outside EPZ (Export Processing Zone) could be done on a transfer application and Cusdec (Customs Declaration) is not necessary*'.

Therefore, the observation made by the BOR that the Appellant could have obtained the required information from the Customs Department is without merit.

The Appellant had also submitted the approvals obtained from the BOI for the transfer of fabric to the two subsidiaries ('A 9'), which is one of the requirements specified in Section 2 (3) (b) of the VAT Act to claim the VAT exemption. The BOI stamp granting the approval is affixed on the commercial invoices attached to 'A 9'. It is important to observe that in the approval granted by the BOI ('A 9'), under items (2), (iv) and (v), the expected date of export and the export order number are also mentioned. Further, the type of the fabric, manufactured item, the quantity etc are also stated. Therefore, it is clear that the transfer of fabrics, manufacture of those into garments and export of such garments were done under the direct supervision of the BOI. The documents 'A 9', 'A 11' and 'A 12 (a)' support the Appellant's assertion that the Appellant imports fabrics, manufactures them into garments and finally exports them.

In the case of *Ceylon Quartz Industries (Private) Limited v. The Director General of Customs and Others*[13] Her Ladyship Shirani Bandaranayake, C.J., having examined the clauses in an agreement entered into with the BOI under Section 17 of BOI Act, observed that *'... if any governmental authority is to examine the correctness of any declaration made and for such purpose exercise such power in such manner, the said direction should be given by the BOI'*.

It was further observed that *'if the objectives of the BOI is to attract investments by giving them special concessions on the basis of its agreements, it would be the duty of the BOI to ensure that such agreements are fully complied with, without any undue interference'*.

Accordingly, it is obvious that the BOI is the superseding authority in the matters relating to transfer of fabrics in issue.

[13] SC Appeal No. 79/2002, decided on the 4th October 2012.

In *Vallibel Lanka (Pvt) Ltd v. Director General of Customs*[14] Sripavan J., (as His Lordship was then) observed that '*it is the established rule in the interpretation of statutes levying taxes and duties, not to extend the provision of the statutes by implication, beyond the clear import of the language used or to enlarge their operation in order to embrace matters not specifically pointed out. In case of doubt, the provisions are construed most strongly against the state and in favour of citizens. Thus, the intention to impose duties and/or taxes on imported goods must be shown by clear and unambiguous language and cannot be inferred by ambiguous words*.'

In my view Section 2 (3) (b) specifically provides for an exemption from VAT for specified transfers of fabrics. The BOR failed to give due weight to the fact that the documents had been taken over by the IRD, and placed the onus of proving the exemption invoked by the Appellant solely on the Appellant.

In view of the above analysis, I answer questions of law No. (i), (iv), (v) and (vi) in the affirmative, in favour of the Appellant.

ii. Did the Appellant company misconstrue and/ or misapply and/ or violate the provisions of section 7 (2) (b) of the VAT Act in the manner of transfer of fabrics to its fully owned subsidiaries particularly when, ex facie, they were not arms-length transactions?

Arm's length transactions are ordinarily the transactions in which two or more unrelated and unaffiliated parties agree to do business, acting independently and in their self-interest. The word 'arm's length transaction' is defined in the Black's Law Dictionary[15] as follows;

'A transaction between two unrelated and unaffiliated parties. 2. A transaction between two parties. However closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises.'

Accordingly, it is not the relationship of the parties what matters but, the nature of the transaction.

[14] SC Appeal No. 26/2008, decided on the 29th August 2008.
[15] Eleventh Edition Vol. 1 p. 1802 Lexus Nexis.

As I have already stated above in this judgment, the Appellant as well as the other two companies, P.M.K. Garments (Pvt) Limited and Inatub Garments (Pvt) Limited are hundred percent export-oriented companies registered with the BOI and entered into agreements under Section 17 of the BOI Act. The transfer of fabrics in question was done with the approval of the BOI, where the said fabrics had to be converted into apparels and exported. It is the duty of the BOI to ensure that the companies act in accordance with the said agreements.

The fact that the two companies are subsidiaries and/or associate companies of the Appellant company remained undisputed until the Appellant filed its second written submissions in this Court on the 24th July 2018. The Appellant, in the said written submissions asserted that the shareholders of the Appellant company and the other two companies are the same, but these two companies are independent companies registered with the BOI and have signed agreements under section 17 of the BOI Act. In contrast to its previous positions, the Appellant submitted that the two companies are not subsidiaries of the Appellant. At the outset the Appellant's position was that both companies are subsidiaries of the Appellant company[16]. The Appellant later stated that they were associated companies of the appellant[17]. In fact, there was no evidence before the Court that the Appellant company possesses shares of both companies and that it had the power to control as a holding company. Be that as it may, even if the two companies are subsidiaries of the Appellant company, the three companies are legally recognized as separate legal entities and their tax and debt are paid by the individual company.

Moreover, the provision of Section 2 (3) (b) applies to ***any person*** who has entered into an agreement with the BOI under Section 17 of the BOI Act and transferred fabric imported by him to ***any other person*** with the approval of the BOI. Hence, it is clear that the application of Section 2 (3) (b) is not limited to arm's length transactions.

It is a well-known cannon of interpretation of statutes that Court cannot read more in the words than is meant.

On reading words into a statute, Bindra states that:

[16] Written submissions of the Appellant dated 28th September 2009 filed in the Board of Review
[17] Paragraph 7 of the Appellant's written submission filed in this Court on the 24th August 2015

'It is not open to add to the words of the statute or to read more in the words than is meant, for that would be legislating and not interpreting a legislation. If the language of a statutory provision is plain, the Court is not entitled to read something in it which is not there, or to add any word or to subtract anything from it.'

Above all, as it was correctly pointed out by the Appellant, although the BOR has raised question No. (ii) in relation to Section 7 (2) (b), it has no relevance to the matter in issue. According to Section 7 (1) (a), when a supplier of goods has exported those goods, they are zero rated. Section 7 (2) provides that; (a) no tax shall be charged in respect of such supply and (b) the supply in all other respects be treated as a taxable supply and accordingly the rate at which tax is charged on the supply shall be zero. Therefore, Section 7 (2) (b) is a provision that provides that no tax should be charged on a zero-rated supply and that it is not a charging provision.

Therefore, in light of the foregoing analysis, I am of the view that there is no basis for holding that the Appellant has misinterpreted and/or misapplied and/or violated Section 7 (2) (b) of the VAT Act. Accordingly, I answer question of law No. (ii) in the negative, in favour of the Appellant.

(iii) Was it not the onus placed on the Appellant Company to satisfy the Revenue regarding the absence of any intention to avoid tax liability by tendering any other evidence, if the original documents were not available and to reconcile the exports figures with the fabrics transferred to its fully owned subsidiaries?

The next issue is whether the Appellant has discharged the onus placed on it to satisfy the Respondent that there was not any intention to avoid tax liability by tendering other evidence, if the original documents were not available.

However, based on the above facts, I am of the view that the Appellant had already presented the necessary evidence to the IRD and more importantly, all possible proof from the BOI as well as from other sources, thereafter. It was the IRD that had taken over the documentary evidence leaving the Appellant in the impossibility of producing the necessary evidence again. At this instance it would be fair for this Court to apply the maxim '*lex non*

cogit ad impossibilia' – the law does not compel a man to do anything vain or impossible or to do something which he cannot possibly perform.

Hence, I am of the view that the BOR erred in directing the Appellant to produce material documents admittedly in the custody of the IRD. Accordingly, I answer question of law No. (iii) in the negative, in favour of the Appellant.

Conclusion

For the reasons set out above, I hold that the BOR erred in law when it arrived at the conclusion that it did.

I, therefore, answer the questions of law in the following manner.

i. **Yes**

ii. **No**

iii. **No**

iv. **Yes**

v. **Yes**

vi. **Yes**

In light of the answers given to the above questions of law, acting under Section 11 A (6) of the TAC Act, I annul the assessment determined by the BOR.

The Registrar is directed to send a copy of this judgment to the Secretary of the Tax Appeals Commission, the successor of the BOR.

JUDGE OF THE COURT OF APPEAL

<u>Dr. Ruwan Fernando J.</u>

I Agree.

JUDGE OF THE COURT OF APPEAL